TWO VIEWS ON INFLATION IN LATIN AMERICA

by Roberto de Oliveira Campos

In several Latin American countries now facing problems of acute inflation, there is a sharp theoretical and policy clash between two groups which, for want of better terms, I shall call the "monetarists" and the "structuralists."

To the "monetarists," views are ascribed that are close to those imputed to the International Monetary Fund, even though several of them dissent from the IMF in many respects. The "structuralists," on the other hand, claim to have support for their views in the studies of the Economic Commission of Latin America, even though official ECLA reports do not show the fatalistic view of the inflationary process in Latin America nor the degree of scepticism toward monetary and fiscal policies that is implied in the "structuralist" view.

In a heroic oversimplification, the views of the two contending schools of thought – at least as expressed in Brazil – can be summarized as follows:

The "monetarists" hold that:

(a) Inflation has ceased to promote development and in fact has become incompatible with it; even those countries that managed to have inflation and development are now facing an acceleration of inflation and a deceleration of development;

(b) Inflation must be stopped quickly, before it degenerates into explosive tensions, and the only effective method seems

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to be the curbing of excess demand through a prudent combination of monetary and fiscal policies supplemented by international financial assistance;

(c) Most of the alleged supply inelasticities and bottlenecks are not autonomous or structural, but are caused by price and exchange rate distortions generated during the course of the inflationary process itself.

The "structuralists," on the other hand, hold that:

(a) Inflation is a natural accompaniment of growth;

(b) Inflation cannot be curbed through monetary and fiscal means without provoking unemployment or stagnation of growth because of supply rigidities;

(c) The instability of export proceeds, generating a capacity-to-import bottleneck as well as supply inelasticities inherent in the growth process, renders it impossible to curb inflation in the short run; it in fact renders desirable a *gradual* attack on inflation, except to the extent that foreign assistance becomes available to render the supply of imports more elastic.

To a certain extent the two contending views are less different than they might seem, the divergences being more of method and emphasis than of substance. There is, however, a *hard core* of dispute which centers mainly on the usefulness of monetary and fiscal policy as well as on the relationship between structural factors and the inflationary process itself.

NOTES ON THE "STRUCTURALIST" VIEW

An implicit assumption of the "structuralist" view is that a sharp distinction exists between the inflationary behavior and policies of less developed countries taken *as a group,* on the one side, and the developed countries as a group, on the other; and accordingly a separate theory is needed to account for such discrepant behavior.

This approach, as noted recently by Arthur Marget, tends to overestimate differences *between* the two groups and slur differences *within* the groups. For instance, *within* the less developed group Brazil followed expansionist monetary policies and is suffering from acute inflation. Mexico pursued more prudent monetary and fiscal policies and has had only a moderate rate of inflation. *Within* the industrialized group, France, until the recent stabilization program, followed inflationary monetary policies while Germany adhered to a conservative approach. It may be said, in this respect, that there is (or was until recently) a greater similarity of behavior between Brazil and France than between Brazil and Mexico.

In short, countries in similar stages of development and achieving comparable rates of growth had varying degrees of inflation and varying monetary experiences, depending on the set of monetary and fiscal policies they chose to adopt.

Is a new or modified theory of inflation, emphasizing supply inelasticities or bottleneck factors which are judged to be inadequately covered by the "demand-pull" or "cost-push" theory, in fact needed for the understanding of inflation in Latin America? Is there room for a "structural" theory of inflation, which would regard changes in money supply as merely passive adjustments to irresistible autonomous pressures generated by bottlenecks in the import capacity, or inelastic food supplies or institutional arrangements?

On the ground of the data and comments I have seen, this effort at theorizing would seem an exercise in "unnecessary" originality; but I am of course open to persuasion.

To naïve and unsophisticated minds like my own, a number of questions would occur immediately: Why not undertake a statistical effort to detect such correlation as may exist for different countries in Latin America, between (A) expansion of the effective money supply,[1] indicating a passive behavior of the monetary authorities, (B) rate of price inflation, (C) rate of growth in real product?

A few things would undoubtedly stand out.

(a) In the heavily inflated countries the rate of expansion in the money supply has been of such an order of magnitude (20 to 30 per cent per year) as to outstrip any realistic possibility of growth of the supply (via increases in the real domestic product plus net imports); at that rate of mone-

1. Supply of money corrected by changes in velocity; strictly speaking the relevant concept would be that of "changes in liquidity," involving not only money but also "near-money." But (a) near-money is less important in Latin America because of incipient financial markets, (b) data are not usually available on money market assets.

tary expansion no economy, even though highly developed and presumably exempted from major inelasticity or supply bottlenecks, would fail to have inflation.

(b) No clear relationship appears to exist (if anything the correlation is negative) between the rate of inflation and the rate of development. The highly inflated countries (Argentina, Chile, Bolivia) tended to stagnate; some of the low-inflation countries (Mexico, Venezuela, El Salvador, Ecuador) seem to be developing fast. For the others there is a mixed picture but it may be said tentatively that (1) where inflation coincided with rapid development, the latter can best be explained by other factors (absorption of foreign resources, improvement in the terms of trade) than by the full utilization of capacity supposedly brought about by inflation, (2) in recent periods the acceleration of inflation has coincided with a deceleration of development.

(c) The above data would give a *first hint* that the behavior of inflation in Latin America would seem to conform pretty much to what might be expected in the light of old-fashioned theories.

It might of course be argued that the above investigation would merely represent a *tautological* illustration of the inflationary process. The relevant question then would be: Why is it that the monetary authorities in Latin America find it so peculiarly difficult to behave actively and usually confine themselves to register on the liability side (money supply) all of the asset creation plans of the government sector, private sectors and net foreign balance? Several answers might suggest themselves:

(1) *Those pressures are irresistible in the process of growth.* This answer would *prima facie* be unsatisfactory as (a) some of the Latin American countries achieved high rates of growth without inflation or with moderate inflation, (b) even the overinflated countries (Brazil, Argentina) have achieved, in discontinuous periods of their history, rapid growth with nothing like their present inflation, (c) given demand pressures for governmental or private investment in development programs, it does not follow that the money supply must be passively adjusted to ratify those programs; after all, investment programs can be financed by taxes, by foreign loans, by physical rationing of consumption, by shifts in the composition of investment, etc.

(2) *Supply inelasticities, institutional rigidities and the capacity-to-import bottleneck (pressures from the real or income side) are the active factors and monetary expansion a residual.* This line of argument would encounter the same difficulties mentioned above, namely, (a) some countries managed at times to control inflation despite bottlenecks and (b) there is no intrinsic organic reason why bottlenecks and inelasticities should be greater in Brazil and Argentina, for instance, than in Mexico or Ecuador. Again it is very difficult to resort to bottlenecks and inelasticities to explain the Argentine inflation at the beginning of the Peronist era.

The upshot of this initial statistical effort would be to bring out clearly, to my mind, that the role of old-fashioned monetary and fiscal policy is vitally important. Money factors are not residual but at the very core of the process. The inflated countries are those that choose incompatible targets.

The Role of Inelasticities and Bottlenecks

It is an underlying assumption of the "structuralist" school that such inelasticities are (a) peculiarly inherent to the growth process in Latin America, (b) autonomous and causal factors of inflation.

A visitor to ECLA in Santiago cannot help feeling that the thinking of the "structuralist" school has been affected by the peculiarities of the Chilean inflation and fell into the trap of generalizing this experience. Chile has had, I am told, almost 95 years of fairly continuous inflation; the attempts to fight it were until recently half-hearted efforts to conceal an open inflation by converting it into a *repressed inflation,* which created still more distortions than the open one. In the course of the process, price or exchange rate distortions discouraged investment in certain sectors (food production, transportation, power, exports) and bottlenecks arose; these bottlenecks now appear to have caused the inflation when they actually resulted from it. It is true that, once generated, bottlenecks may begin to play an independent causal role; and they certainly render the fight against inflation more difficult. In this sense the original *variables* have been converted into *data* of the problem; but this does not invalidate the basic distinction between *natural* bottlenecks and *induced* ones.

Structural bottlenecks indeed come to one's mind when discussing the Chilean inflation; somehow they seem much less relevant when one discusses the Mexican or Venezuelan situation. And for the Argentine inflation, only a fertile imagination would attribute a causal role to bottlenecks and food supply inelasticities; they were the result of Peronist policies (pegging of rates of public utilities and transportation, taxation of agricultural exports to subsidize industrialization, etc.) and not the causal factor of the Argentine inflation, even though they now complicate tremendously the problem of combating it.

We all recognize of course that there are *leads* and *lags* in the development process; balanced growth, *stricto sensu,* is almost a practical impossibility. But it does not mean that these need to become cumulative and self-feeding; this only happens when policies are pursued that convert self-correcting disequilibria inherent in the growth process into induced and cumulative ones.

A *model* explaining one of the possible methods of bottleneck generation could thus easily be constructed in the following fashion:

(1) Excess demand arising from the pressures in the foreign sector (wartime export surpluses not offset by unspent export taxes or by imports) led to price inflation.

(2) Attempts were made to repress inflation not by curbing general excess demand but by controlling certain key prices (basic foodstuffs, rail transport, electricity, interest rates).

(3) Private voluntary savings and investment were discouraged and replaced, after a time lag, by deficit-financed government investment.

(4) Inflation was aggravated, bottlenecks arose and "structural rigidities" were created.

On the basis of the Latin American experience it may be quite possible to demonstrate that, to a large extent, the alleged bottlenecks were originally inflation-induced, even though at a later stage they may become inflation-feeding.

(a) *Bottlenecks in transport and electricity.* In most Latin American countries (Argentina, Brazil in particular) utility rates have been congealed, or the capital base for rate determination frozen at the "historical" cost, despite rising costs. Results: (a) stoppage of investment, (b) net disinvestment, (c) bottlenecks.

(b) *Food supply.* Rather than curbing general excess demand it seems infinitely easier for governments to establish price control of basic foodstuffs leading to the following results:

– in the case of food for internal consumption:

(i) subsidization of demand for consumption, thus aggravating the price pressure;

(ii) reduction in the relative profitability (as compared with industry or the import trade, for instance) of the food production sector and consequently disincentive for investment in agriculture;

(iii) diversion of land from productive to unproductive uses.

– in the case of agricultural production for export:

(i) emergence of repressed inflation through overvalued *exchange rates* that tax export production;

(ii) manipulation of internal producers' prices by state export monopolies that tax the export sector in order to subsidize industry.

(c) *Rigidity of the savings function.* Freezing of interest rates to decrease costs for investors acts as a tax not on spenders but on savers; in many cases, legal interest rates become negative, forcing would-be savers to de-monetize their savings by investing in real estate or in foreign currency, or else to run the risk of irregular financial transactions to achieve a positive interest rate.

(d) *Import capacity bottleneck.* A prolonged inflation is obviously a powerful generator of "capacity-to-import" bottleneck. In Latin America the countries that suffer acutely from such bottlenecks are precisely those that have indulged in multiple-rate practices. And this of course is not a mere accident of fate, for various reasons.

(i) There are usually subsidized rates for certain basic or so-called "rigid" imports that are held to be important cost-of-living items (fuel, wheat) as well as for machinery and equipment for essential projects. The net result is that wasteful consumption is encouraged, there is a perverse substitution (against the competing national product or substitute product), investment demand is overstimulated by the artificial reduction of the private cost to the entrepreneur, but often with an increase in social costs to the economy as a whole.

(ii) Subsidized import rates go hand in hand with pegged rates for certain exports which thereby become subject to heavy taxation; this results in a disincentive to expansion and diversification of exports. There are of course cases when export taxes are advisable and necessary (to create stabilization funds, to correct domestic overproduction, etc.) and the multiple-rate mechanism may be a convenient and flexible technique for taxing exports. But clearly many of the Latin American countries have abused multiple-rate practices and come dangerously close to killing the hen that laid the golden eggs. (Argentina is a case in point.)

The purpose of these notes is not to deny that once supply inelasticities have been created through a long process of inflation (1) they may begin to exert a derived causal role, (2) they make the combat against inflation more difficult and painful than it need otherwise be, (3) stabilization programs may have to adjust themselves to the fact that in its initial phases the repressed inflation may have to be converted into an open one (prices in the controlled sectors being allowed to rise in order to correct previous bottleneck-creating price distortions), (4) the combat against inflation would require monetary and fiscal policies in a broad sense, including programs for a more productive reorientation of public and private investment, as well as a foreign aid component.

A Note on the Capacity-to-Import Bottleneck

It is often somewhat uncritically assumed that a limited capacity to import is an independent datum of the inflationary process in Latin America. Even though this may be true in the very short run it is important to determine to what extent it is again an "induced" bottleneck arising from deliberate policies that combined internal inflation with external overvaluation, and aimed at financing the rise of import substitution through export taxes, rather than through general taxation and other incentives; or from the lack of foresight in building up reserves in boom periods to avoid excessive import contractions in loan periods.

Practically all of the inflated Latin American countries biased their development program in an anti-export direction. That is most certainly the case in Brazil and Argentina; Chile also discouraged for a long time the expansion of copper investments, and through multiple rates, which have the effect of export taxes, discouraged diversification of exports.

Mexico and Venezuela did not indulge in development policies biased against exports and did not experience the same acute import capacity bottlenecks. Nor can the problem be assumed away simply by saying that Mexico had naturally elastic exports in the form of tourism and Venezuela enjoyed the oil and iron ore bonanza. The fact is that Venezuela might have adopted policies that would hinder investment in oil and minerals, as Brazil (in the case of minerals and oil) and Argentina (in the case of oil) managed to do rather effectively, and Mexico might not have cashed in on Brazilian and U. S. mistakes on coffee and cotton.

But even when the effect of inadequate export policies is discounted, it may well be that there is a residual bottleneck in the capacity to import. This is in fact likely to be the case whenever exports cease to be (and there is no reason why they should always be) the leading "growth" sector of the economy. In other words, it is quite conceivable that exports may tend to grow at less than the required rate, despite the adoption of rational development programs. This may be because of long-run downward terms of trade, lower income and/or price elasticities of demand for primary products, etc. (e.g., Prebisch's thesis, which may have validity in the case of certain countries and products because of the combined effect of Engels' law, technological savings in raw materials, synthetic substitutes, or an ambivalent behavior of mining concerns as exporters of raw materials in less developed countries and consumers in developed countries, etc.).

This situation in fact was envisaged in good old classical international trade theory. This "natural" as opposed to an "induced" lag in the rate of export growth as compared to the overall rate of development is indeed implicit in Cairne's time-honored theory about the stages through which a developing country's balance of payments is likely to pass. Young debtor countries are supposed to have an import surplus covered by loans; as they mature the inflow of loans is offset by debt payments; finally, they become capital exporters and develop an export surplus.

Upon those who emphasize the limitations of the capacity to import as an "original" and almost unavoidable bottleneck explaining a good part of the irresistibility of inflationary "real" pressures in Latin America rests the burden of proving that this bottleneck has not gone beyond the normally expected gap, precisely as a result of inflationary policies and anti-export-biased development programs. The severe constriction of the import capacity in Brazil and Argentina, for instance, seems to have been engineered by (a) excessive export taxation through exchange rate or price distortions, (b) misguided import substitution policy, (c) the wrong method of financing import substitution.

On the Active or Passive Behavior of the Monetary Authorities

There seems to prevail among the "structuralists," alongside an underestimation of monetary policies, a much too narrow concept of what is meant by monetary and fiscal policy.

Clearly, given pressures emerging from public expenditures, volume of investment and export volume, the monetary authorities need not act passively but may react in a number of ways. Given, for instance, an autonomous wage increase of political origin, the monetary authority may choose to allow credit expansion by a margin considerably smaller than the cost-push. In this case it will force the entrepreneur to absorb part of the cost increase, through reduction in profits, to liquidate inventories, and/or to increase productivity. Nor can it be assured that the fatal result of such measures will be unemployment and reduction in the level of real investment in industry. If the entrepreneur considers the governmental policy to be firm and irreversible he may not choose to contract employment or investment in the industry but will rather monetize real assets (real estate, buildings, etc.), liquidate "near-money" assets, or reduce personal consumption. If of course the monetary authority starts from the fatalistic assumption that the cost-push pressures cannot be resisted without unemployment or reduction in real investment, then there is no "monetary" cure for inflation. But then there is no "real," "structural" or "institutional" cure either. For the basic contradiction of the "structuralist" view seems to be that precisely because the "structuralists" emphasize the sluggishness of supply in less developed countries and the import limitations, they ought to conclude logically that the only possible effective attack on inflation would be a contraction of excess demand; precisely what the "monetarists" have advocated all along.

The research on bottlenecks is of course extremely useful for fiscal and monetary policy to play an even more useful active role; and that is the line of reconciliation between "monetarists" and "structuralists." For a lot can be done by fiscal and monetary weapons to correct bottlenecks without additional investment that would merely aggravate excess demand; this can be done simply through the alteration of price incentives and reorientation of government investment from less productive to the bottleneck sectors (shift from military expenditures to investment in agriculture). Nor can it be assumed, as many "structuralists" assume, that a reduction of the over-all investment level in the course of stabilization programs is detrimental to growth. In the first place, this reduction may be purely temporary, soon reversed by an upsurge in investment. In the second place, a better composition of investment may emerge (with the reduction of speculative investment) with a consequent improvement in the capital-output ratio, so that a lower over-all volume of investment may be compatible with an acceleration of real growth.

It remains to be seen whether this will in fact be the result of some of the stabilization programs now attempted in Latin America (Argentina and Colombia, for instance). In my view there is a fair chance that this will occur.